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IN THE

Supreme Court of the United States

OCTOBER TERM, 1946

No. 92

WALTER P. GARDNER, Trustee, of the Central Railroad Company of New Jersey,

Petitioner,

vs.

STATE OF NEW JERSEY,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF GROUP OF INSTITUTIONAL INVESTORS, WATTERS COMMITTEE OF BONDHOLDERS, BROOKS COMMITTEE OF BONDHOLDERS AND CENTRAL HANOVER BANK & TRUST COMPANY AS *AMICI CURIAE*

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November 6, 1946.

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR *AMICI CURIAE*

Statement

The undersigned members of the bar of this Court file the attached brief as *amici curiae*, pursuant to Rule 27 (9), on behalf of the Group of Institutional Investors, the Watters Committee of Bondholders, the Brooks Committee of Bondholders, and the Central Hanover Bank and Trust Company. There have been filed with the Clerk of this Court the written consents of all parties who have entered appearances here in this case.

This cause is here on certiorari to review the judgment of the Circuit Court of Appeals for the Third Circuit entered November 15, 1945 in the reorganization proceed-

ings under Section 77 of the Bankruptcy Act of the Central Railroad Company of New Jersey, reversing a judgment of the United States District Court for the District of New Jersey, entered March 5, 1945, holding that the District Court as a bankruptcy court had jurisdiction to adjudicate claims for taxes and penalties or interest filed by the State of New Jersey in the reorganization proceedings.

The parties joining in this brief consist of groups or committees of bondholders holding in the aggregate approximately one-quarter of the General Mortgage Bonds of the Central Railroad Company of New Jersey, and the Trustee of the General Mortgage, which constitutes a lien upon the properties and assets of the Debtor, and secures the only outstanding issue of the Debtor's bonds. They are the principal bondholder creditor parties to the reorganization proceedings, and were joined as appellees by the State in the Circuit Court. The writers of this brief concur in and adopt the statement of the case made by the petitioner, including his assignment of errors.

Summary of Argument

POINT I. THE BANKRUPTCY ACT GIVES THE BANKRUPTCY COURT JURISDICTION OVER THE PROOF AND ALLOWANCE OF CLAIMS, INCLUDING TAX CLAIMS.

1. Section 77 gives the court broad powers over proof and allowance of claims.
2. The language of Section 77 closely parallels that of the subsequent Section 57n, which Congress explicitly made applicable to tax claims.
3. The whole scheme of the Bankruptcy Act and the interpretation long given it by the courts make the Bankruptcy Court the proper forum for the evaluation and enforcement of liens.

4. It is even more important in reorganization cases than in ordinary bankruptcy that the Bankruptcy Court should be the forum for adjudication of lien disputes.

5. The question whether increment to taxes should be allowed as interest, disallowed as a penalty, or otherwise limited, is also a matter of Bankruptcy Law.

6. The contention that governmental lien creditors stand on a different footing from other governmental creditors is without support in the statute.

7. The Bankruptcy Court has jurisdiction not only of property to which the debtor had title, but all property of which the debtor had possession.

8. The Bankruptcy Court's power in this case is not dependent upon Section 64 of the Statute.

9. It being clear that the statute gives the Bankruptcy Court jurisdiction to evaluate liens, the only remaining contention is that the Bankruptcy Act is unconstitutional; and the Act's constitutionality has never before been challenged on such a ground because it has never occurred to anyone to view a state's efforts to enforce liens as suits against the State.

POINT II. THE CIRCUIT COURT ERRED BY MISTAKING THE JURISDICTIONAL QUESTION AT ISSUE IN THIS CASE FOR AN ATTACK ON THE ASSESSMENT METHODS OF NEW JERSEY, AND THUS DECIDED A QUESTION WHICH WAS NOT BEFORE IT.

1. The Circuit Court's opinion shows that it viewed the case as an attack on a tax assessment.

2. Loose reference to questions of law and pleas of *res judicata* as "jurisdictional" disguise the fact that the Bankruptcy Court very properly passed on nothing but the one jurisdictional question whether the State might claim sovereign immunity.

POINT III. THE CIRCUIT COURT ERRED IN HOLDING THAT THE DISTRICT COURT HAD NO JURISDICTION TO DETERMINE WHETHER A VALID TAX SETTLEMENT HAD BEEN MADE BY THE STATE AND THE TRUSTEES IN BANKRUPTCY.

1. By its holding the Circuit Court prevented a determination by the District Court of the question whether a valid tax settlement had been made by the State and the Trustee in Bankruptcy superseding the original assessment.

2. Whether such a settlement binding on the State has been made is a question of fact clearly within the jurisdictional competency of the District Court.

ARGUMENT

POINT I

The Bankruptcy Act gives the Bankruptcy Court jurisdiction over the proof and allowance of claims, including tax claims.

1. Section 77 Gives the Court Broad Powers Over Proof and Allowance of Claims.

Section 77 (c) (7) of the Bankruptcy Act provides:

> "The judge shall promptly determine and fix a reasonable time within which the claims of creditors may be filed or evidenced and after which no claim not so filed or evidenced may participate except on order for cause shown, the manner in which such claims may be filed or evidenced and allowed, and for the purposes of the plan and its acceptance, after notice and hearing, the division of creditors and stockholders into classes according to the nature of their respective claims and interests."

Section 77 (b) provides:

> "The term 'creditors' shall include, for all purposes of this section *all holders of claims of whatever character against the debtor or its property*, whether or not such claims would otherwise constitute provable claims under this Act, including the holder of a claim under a contract executory in whole or in part including an unexpired lease." (Emphasis added.)

The term "claims" is likewise broadly defined:

> "The term 'claims' includes debts, whether liquidated or unliquidated, securities (other than stock and option warrants to subscribe to stock), liens, or other interests of *whatever character.*" (Emphasis added.)

In addition to the specific grant of jurisdiction made by these paragraphs of Section 77, the jurisdiction to adjudicate tax claims and lien disputes concerning the estates in their possession which bankruptcy courts were exercising long before the enactment of Section 77 is given to the reorganization court by Section 77 (l), viz.:

> "In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and its property, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed."

Under the provisions of the statute, any claim which is not filed or evidenced within the time fixed by the judge is excluded from participation in the estate, an exercise of the

Congressional bankruptcy power which is certainly more drastic in its effect on tax liens than the mere grant to the court of the inherent power to determine the validity and extent of liens. That the exclusion of tardy claims from participation applies to tax liens is clear from the sweeping terms of 77 (b). "Claims" includes explicitly "liens or other interests of whatever character" and "creditors" includes "all holders of claims of whatever character". It would be hard to conceive of broader language. Not only are creditors defined as holders of claims "of whatever character", but they include "all holders", private or otherwise, and "claims" includes liens or "other interests of whatever character". A claim for taxes is at the very least an "interest". There are few more all-inclusive words in the legal vocabulary. Moreover, the provisions of Section 77 (c) 7 give the court power not only over the time of filing claims, but over the manner of filing and the manner in which they shall be allowed. They set up a scheme for the orderly and equitable handling of claims which is a *sine qua non* of any reorganization statute, and it is absurd to think that large classes of claims, or any class, could have been deliberately left out. There is nothing in the language that can remotely be construed as an exclusion; indeed, the definition of creditors as including holders of claims whether or not provable under the Act manifests an intention to grant even broader jurisdiction than given to bankruptcy courts under the earlier sections of the Act.

These provisions are not ambiguous. Their purpose is plain that the bankruptcy court shall fix the time within which all claims, whether secured or unsecured, shall be filed and the manner in which they shall be allowed. The District Court in this case entered an order in accordance with the statutory provisions and the State properly acted

thereon in filing its claim. These provisions, which expressly authorize the judge to determine the manner in which claims may be allowed, are all inclusive and, as a necessary prerequisite to consummation of a plan, must include tax claims as well as claims of any other character.

2. The language of Section 77 closely parallels that of the subsequent Section 57n, which Congress explicitly made applicable to tax claims.

The broad scope of the jurisdiction granted by Section 77 to adjudicate claims is indicated by reference to Congressional action with respect to other parallel provisions of the Bankruptcy Act. Prior to the 1938 amendments to the Bankruptcy Act, Section 57n contained no such broad and all-inclusive language as that incorporated in 1933 in Section 77 (c) 7. However, in 1938, the comprehensive revisions of the Act included a drastic amendment to Section 57n, doubtless in the light of the provisions of Section 77 (c) 7 adopted five years previously. The new language brought the former section into line with the previously broader provisions of the latter by providing:

> "n. Except as otherwise provided in this Act, all claims provable under this Act, including all claims of the United States and of any State or subdivision thereof, shall be proved and filed in the manner provided in this section. Claims which are not filed within six months after the first date set for the first meeting of creditors shall not be allowed: *Provided,* however, that the Court may, upon application before the expiration of such period and for cause shown, grant a reasonable fixed extension of time for the filing of claims by the United States or any State or subdivision thereof: * * *"

The Committee reports left no doubt as to the intent of Congress. The House report stated:*

> "(3) *Claims—Filing.*—Section 57: Subdivision n relating to the filing of claims has been entirely recast, and several significant changes have been made.
>
> "*All proofs of claim, except as otherwise provided in chapters X, XI, XII, and XIII, including claims for taxes and debts owing to a government, must be filed and proved.* The provision in respect to government claims is added in order to overcome the decisions which hold that the bar time for the filing of claims is not binding upon a sovereign. Thus the administration of the estate is speeded up, and the distribution becomes more certain and definite." (Emphasis added.)

The importance of this change was twice referred to in the Senate report:†

> "5. *Including Government claims within bar time—Extension of time*—(Section 57, Subdivision n, p. 76, lines 7 and 10-13). The House Bill includes within the bar time for the proving of claims, all claims of the United States and of any State or subdivision thereof. The committee has both strengthened and extended this proposed amendment by providing, first, that such claims must actually be filed within the bar time, and, second, by permitting additional time for the filing of such claims upon application for cause shown. *The committee agrees with the proposal that governmental claims should be subjected to the same requirements as other claims* but is of the opinion that the limitation should be tem-

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* House Report No. 1409 to accompany H. R. 8046, 75th Cong. 1st Sess. at p. 13.

† Senate Report No. 1916 to accompany H. R. 8046, 75th Cong. 3d Sess. at pp. 5, 16.

pered by the provision for extension, for the reason that it is sometimes difficult for the Government to prepare and present its claims within a fixed time. *The limitation will speed up the closing of estates,* and the extension will provide a reasonable flexibility.

* * * * * * * * *

"The provisions relative to the proof and allowance of claims have been greatly improved. Reference has already been made with reference to contingent claims and concerning the filing of Government claims and the extension of time therefor." (Emphasis added.)

It will be observed that the very purpose of this provision was to "subject governmental claims to the same requirements as other claims", a purpose already accomplished as to railroad reorganizations by the broad language of Section 77.

3. The whole scheme of the Bankruptcy Act and the interpretation long given it by the courts make the Bankruptcy Court the proper forum for the evaluation and enforcement of liens.

It is apparent, almost from the nature of the bankruptcy process, let alone from the statutory grant of power recited above, that the objections raised to the State's proof of claim must necessarily be heard and determined by a bankruptcy court. In this connection, attention is directed to the third and fourth objection to the State's proof of claim made by intervening creditors (R. 113-115). Objection 3(a) states that the State has no lien superior to the mortgagees' for amounts other than the principal of the taxes, and that the imposition of such a lien at that date would violate the rights of the mortgagees under the Fourteenth Amend-

ment. This is a question of relative priority of liens on a bankrupt estate, and citation of cases is almost superfluous to show that such a question is of the very essence of bankruptcy and reorganization law. Objection 3(b) is to the effect that the State has no lien on the personal property of the debtor for amounts greater than the principal of the taxes.

In *Isaacs* v. *Hobbs Tie & Timber Co.*,* this court said:

> "This is but an application of the well recognized rule that when a court of competent jurisdiction takes possession of property through its officers, this withdraws the property from the jurisdiction of all other courts which, though of concurrent jurisdiction, may not disturb that possession; and that the court originally acquiring jurisdiction is competent to hear and determine all questions respecting title, possession and control of the property. * * * *Thus, while valid liens existing at the time of the commencement of a bankruptcy proceeding are preserved, it is solely within the power of a court of bankruptcy to ascertain their validity and amount and to decree the method of their liquidation.*" (Emphasis added.)

In *Straton* v. *New*,† this Court said:

> "The purpose of the Bankruptcy Law, passed pursuant to the power of Congress to establish a uniform system of bankruptcy throughout the United States, is to place the property of the bankrupt, wherever found, under the control of the court, for equal distribution among the creditors. The filing of the petition is an assertion of jurisdiction with a view to the determination of the status of the bankrupt and a settlement and distribution of his estate. This jurisdiction is exclusive within the field defined

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* 282 U. S. 734, 737-738 (1931).
† 283 U. S. 318, 321 (1931).

> by the law, and is so far in rem that the estate is regarded as in custodia legis from the filing of the petition. . . . It follows that liens cannot thereafter be obtained nor proceedings be had in other courts to reach the property, the district court having acquired the exclusive right to administer all property in the bankrupt's possession. . . . *It may inquire into the validity of liens, marshall them, and control their enforcement and liquidation.*" (Emphasis added.)

These cases are only the latest expressions in the line of authority going back to *Whitney* v. *Wenman*,* in which the Court said:

> "We think the result of these cases is, in view of the broad powers conferred in Section 2 of the bankrupt act, authorizing the bankruptcy court to cause the estate of the bankrupt to be collected, reduced to money, and distributed, and to determine controversies in relation thereto, and bring in and substitute additional parties when necessary for the complete determination of a matter in controversy, that when the property has become subject to the jurisdiction of the bankruptcy court as that of the bankrupt, whether held by him or for him, jurisdiction exists to determine controversies in relation to the disposition of the same, and the extent and character of liens thereon or rights therein."

4. It is even more important in reorganization cases than in ordinary bankruptcy that the Bankruptcy Court should be the forum for adjudication of lien disputes.

Ascertaining the validity and relative priority of liens is even more conspicuously a primary duty of the bankruptcy court in a railroad reorganization case. In such a

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* 198 U. S. 539, 552 (1905).

case the corpus of the estate is almost entirely covered by liens. Disentangling the various liens, placing them in their proper rank, and estimating their value (so far as possible) are obviously indispensable first steps before the distribution of new securities under a plan of reorganization can be mapped with any pretense at fairness and equitability. In *Institutional Investors* v. *Chicago, Milwaukee, St. Paul & Pacific Railroad Company,* the Court said, "Here, as in the Consolidated Rock Products Company Case, the 'determination of what assets are subject to the payment of the respective claims' has a direct bearing on the fairness of the plan. . . . ." * It was there held that the District Court must resolve disputes as to liens.

5. The question whether increment to taxes should be allowed as interest, disallowed as a penalty, or otherwise limited, is also a matter of Bankruptcy Law.

The fourth objection made by intervening creditors to the State's proof of claim also concerns the accruals claimed by the State in addition to the principal amount, it being argued alternatively that they constitute a penalty not provable under the Act, or that for other reasons grounded in the peculiar circumstances of the case (which necessarily are not part of the present record and so are not before this Court and were not before the Circuit Court of Appeals) they should not accrue after the date of bankruptcy at the rate claimed by the State. The question whether an accrual is penalty or interest is one which has frequently come before bankruptcy courts for determination, sometimes with the result that the accrual was determined to be a

* 318 U. S. 523, 569 (1943).

penalty as in *New York* v. *Jersawit*,* sometimes with the opposite result, *Meilink* v. *California Unemployment Reserves Commission*.†

6. The contention that governmental lien creditors stand on a different footing from other governmental creditors is without support in the statute.

The proposition that a bankruptcy court has jurisdiction to determine the extent of liens is, as we have shown, almost axiomatic. The Circuit Court, as we shall attempt to demonstrate later, mistakenly grasped at one of the substantive objections to the State's proof of claim, assuming it to be the sole question in the case, and decided that rather than the jurisdictional question, which was the only one before it. The State's position, as we understand it, is that the assertions made in the State's proof of claim as to the existence and extent of its lien must be taken as final and cannot be inquired into, else the sovereign immunity of the State would be violated. There is no support in the statute for such a view.

The whole rationale of bankruptcy, of the marshalling and distribution of the assets of an insolvent estate, requires that a bankruptcy court be permitted to pass upon disputes over taxes secured by a lien even as upon disputes over unsecured taxes. If it were otherwise, not only states, but municipalities and other lesser taxing authorities, could, by the mere assertion of a lien, carve huge chunks out of the insolvent estate. There would be no need to determine whether a lien were perfected or inchoate, if it were once asserted; nor whether it had priority over other liens; nor would a

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* 263 U. S. 493 (1924).
† 314 U. S. 564 (1941).

bankruptcy court be allowed to determine the share of administrative expenses incurred in preserving property to which a lien had been asserted. The struggle over the corpus of an insolvent estate would be fought out not only in the bankruptcy court but in the tax bureaus, in the state tribunals and elsewhere.

If mere assertion of a lien were to free a taxing power from all the restraint imposed on other claimants, the tax claimant could intervene at any time and disrupt administration of an estate after it was well under way. This Court has already rebuked such a contention. In *New York* v. *Irving Trust Company*,* the bankruptcy court directed the filing of proof of all claims which the State of New York had against the bankrupt within 60 days after service of the order. No claim was filed by New York within the prescribed period but subsequently a notice of possible demand for additional taxes was presented. These taxes were secured by a lien.† The Trustee's motion to expunge the notice filed by New York was granted by the district court. Against the claim that this action was incompatible with state sovereignty, this Court upheld the action of the district court, saying:‡

> "The Federal government possesses supreme power in respect of bankruptcies. International Shoe Co. v. Pinkus, 278 U. S. 261, 265, 73 L. Ed. 318, 320, 49 S. Ct. 108. If a state desires to participate in the assets of a bankrupt, she must submit to appropriate requirements by the controlling power; otherwise, orderly and expeditious proceedings would be impossible and a fundamental purpose of the Bankruptcy Act would be frustrated."

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* 288 U. S. 329 (1933).
† *Carey* v. *Keith*, 250 N. Y. 216, 164 N. E. 912 (1928).
‡ 288 U. S. 329, 333 (1933).

The State of New Jersey, in its argument, does not, of course, contemplate such a chaos, where states and municipalities assert liens, and relying upon the finality of their own assertion, proceed eventually to their own execution unless paid off at the other creditors' expense. But such is the inevitable consequence of its interpretation of the statute. The explicit declaration of power to settle tax disputes, the State says, is in Section 64a; Section 64 deals primarily with a scheme of distribution for unsecured assets; therefore, a tax dispute arising as to secured assets must constitute a suit against the claimant. But this argument flies in the face of history and reason. It is far more consistent and sensible to say, as the courts have said for sixty years, that the power to settle disputes over tax claims is one of the powers of a bankruptcy court, whether by virtue of the express language of Section 64a or by virtue of the general grant of power to deal with claims and administer insolvent estates. It does not appear where in the Bankruptcy Act the court derives its jurisdiction to deal with secured tax claims at all, if not from one of these two sources; but the State reads into the statute an immunity only for state tax claims.

There are innumerable decisions where the courts have struggled with the question of proper treatment of tax claims, which could have been turned off quite simply if the assertion or even the establishment of a lien position for the taxes required the bankruptcy court to accept as final the claimant's assertions, upon peril of infringing his sovereign immunity.*

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* *e. g. Arkansas Corporation Commission* v. *Thompson*, 313 U. S. 132 (1941); *Board of Commissioners of Sweetwater County* v. *Bernardin*, 74 F. (2d) 809 (C. C. A. 10th, 1934); *In re Knox-Powell-Stockton Co.*, 100 F. (2d) 979 (C. C. A. 9th, 1939); *Eldredge Brewing Co.* v. *City of Portsmouth*, 118 F. (2d) 410 (C. C. A. 1st, 1941).

Moreover, under the State's interpretation of the Bankruptcy Act, a clash of lien claims between two sovereigns, such as two states or a state and the Federal Government (a not infrequent occurrence), could, if the Bankruptcy Court has no jurisdiction over lien claims, presumably be settled only by plenary proceedings in this Court.

A decisive refutation of the State's contention that the draftsmen of the Bankruptcy Act intended to leave State-claimed liens outside the jurisdiction of the bankruptcy court is found in Section 67 (c), expressly subordinating state tax liens, even when clearly ascertained and valid, on personal property, to wage claims and administration expenses. The inherent power of the Bankruptcy Court to rank and evaluate liens asserted but not otherwise established, surely, is a lesser power than the power to subordinate liens already established. Such a provision is utterly inconsistent with the State's theory that its claim upon the insolvent estate, because allegedly secured by a lien, is thereby withdrawn from the bankruptcy court's jurisdiction under the terms of the Act.

The claim of sovereign immunity under similar circumstances was unsuccessfully asserted in *New York* v. *Irving Trust Co., supra.* There is no question of acquiring jurisdiction over the person of the State to render a personal judgment. Jurisdiction of a *res* in *custodia legis* suffices to adjudicate interests claimed in the *res;* and both the statutes and the cases show that a bankruptcy court has jurisdiction over an insolvent estate sufficient to adjudicate liens therein and otherwise deal with them. The State comes into Court as a claimant, necessarily, and not as a defendant.

7. The Bankruptcy Court has jurisdiction not only of property to which the debtor had title, but all property of which the debtor had possession.

The fundamental fallacy of the State's position in this proceeding arises from its misconception, derived from inapposite language in Sections 64 and 70 of the Bankruptcy Act, that the estate in *custodia legis* consists only of the unencumbered assets to which the Debtor had title. On the contrary, the estate in *custodia legis* consists of all assets of which the debtor had *possession*, whether encumbered or not. So it has been consistently held through fifty years of bankruptcy history.*

That this is so is shown by one of the very quotations that the State cited to the Circuit Court. On Page 23 of its brief, citing *Missouri* v. *Fiske*,† it quoted:

> "The fact that a suit in a Federal Court is in rem or quasi in rem furnishes no ground for the issue of process against a nonconsenting state. If the State chooses to come into the Court as plaintiff or to intervene, *seeking the enforcement of liens* or claims, the State may be permitted to do so, and in that event its rights will receive the same consideration as those of other parties in interest. But when the State does not come in and withholds its consent, the Court has no authority to issue process against the State to compel it to subject itself to the Court's judgment, whatever the nature of the suit." (Our emphasis.)

In this case, there is no question of issuing process against the State. The estate is in *custodia legis*, and if

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* *White* v. *Schloerb*, 178 U. S. 542, 44 L. Ed. 1183 (1900); 2 Collier on Bankruptcy, 14th Ed., Para. 2304, pp. 449-451, and cases there cited.

† 290 U. S. 18, 28 (1933).

the State wishes to enforce its liens it may come in (as it has done in fact). If it does not come in, it runs the risk that its lien may not be enforced, which is squarely and precisely what happened in *Van Huffel* v. *Harkelrode*.*

That bankruptcy administration has always comprehended state liens was clearly indicated in the opinion of Mr. Justice BRANDEIS in *Van Huffel* v. *Harkelrode*. In that case the Supreme Court confirmed the jurisdiction of the bankruptcy court to sell property of the bankrupt free of state tax liens, although it was admitted that the bankruptcy court had erroneously denied priority to the lien. Justice BRANDEIS said: †

> "No good reason is suggested why liens for state taxes should be deemed to have been excluded from the scope of this general power to sell free from encumbrances. Section 64 of the Bankruptcy Act grants to the court express authority to determine 'the amount or legality' of any tax. To transfer the lien from the property to the proceeds of its sale is the exercise of a lesser power; and legislation conferring it is obviously constitutional. Realization upon the lien created by the state law must yield to the requirements of bankruptcy administration."

8. The Bankruptcy Court's power in this case is not dependent upon Section 64 of the Statute.

It will be noted that Justice BRANDEIS apparently thought that Section 64, giving the Bankruptcy Court power to "hear and determine" all disputes as to the "amount and legality" of any tax, was a declaration of power to adjudicate liens. In this respect Section 64 was only declaratory

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* 284 U. S. 225 (1931).
† 284 U. S. at page 228.

of a power granted elsewhere in the Bankruptcy Act. When the draftsmen first came to deal with taxes, in Section 64 of the Act as it stood prior to the 1938 amendments, they added the proviso that the Bankruptcy Court should "hear and determine" disputes regarding taxes, to prevent any confusion arising from the preceding direction that the court should order the payment of taxes. However, Section 64 dealt primarily with a scheme for the distribution of free assets; and for this reason, particularly after it was re-drawn and compressed in 1938, there was doubt as to the extent of Section 64's applicability to secured claims and to reorganizations, so much so that this Court expressly reserved the point as to Section 77, in *Arkansas Corporation Commission* v. *Thompson*. The whole of the State's case as to statutory interpretation is bottomed on the coincidental presence of this clause in Section 64. But it is plain that the power to adjudicate disputes over taxes and liens claimed therefor is inherent in a bankruptcy court, and has always been treated as such. In *Lyford* v. *City of New York*,* the Circuit Court of Appeals for the Second Circuit, in a thorough opinion holding Section 64a not inconsistent with Section 77, and therefore applicable under Section 77 (l), in so far as it dealt with power to adjudicate tax claims, said:

> "Moreover, we do not see that our problem would be greatly changed, however our conclusion is expressed as to this point. If there was no provision expressly dealing with the power to adjudicate tax claims, the court would still have to find that such a claim was legally due; its general power to pass upon claims would require no less." (Id. at p. 785)

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* 137 F. (2d) 782 (1943).

9. It being clear that the statute gives the Bankruptcy Court jurisdiction to evaluate liens, the only remaining contention is that the Bankruptcy Act is unconstitutional; and the Act's constitutionality has never before been challenged on such a ground because it has never occurred to anyone to view a state's efforts to enforce liens as suits against the State.

The only argument of the State which has not been long since settled against it is that the Bankruptcy Act is unconstitutional because it empowers the bankruptcy court to deal with contentions put forward by a state that its tax claims are secured. As far as we are aware, it is the first time the constitutionality of the Bankruptcy Act has been challenged on such a ground.

Heretofore there has been no suggestion that conflict could arise between the bankruptcy power, one of administering insolvent estates, and the Eleventh Amendment, forbidding the prosecution of law suits against a state. But it is not necessary to argue that the Bankruptcy Power overrides the Eleventh Amendment. The real answer is that throughout our history, claimants, whether private or municipal or state, have had to come to the bankruptcy court to present their claim for adjudication; they have not been allowed to proceed to self-help unless permitted by the bankruptcy court. Such an interpretation of the law fulfills the purpose of a bankruptcy court, the centralized, simultaneous and expeditious disposition of claims, and could not possibly be viewed as a suit against the claimant; and therefore no conflict has arisen or can arise between the Bankruptcy Power and the Eleventh Amendment. The de-

cision of this court in *Ashton* v. *Cameron County*,* contains no suggestion to the contrary, since it was grounded not upon the Eleventh Amendment but upon general concepts of state sovereignty.

POINT II

The Circuit Court erred by mistaking the jurisdictional question at issue in this case for an attack on the assessment methods of New Jersey, and thus decided a question which was not before it.

1. The Circuit Court's opinion shows that it viewed the case solely as an attack on a tax assessment.

We believe that the Court of Appeals fell into error because of its too great familiarity with the long history of litigation over New Jersey railroad tax assessments. The question before the Circuit Court was purely a preliminary one of jurisdiction, whether the Bankruptcy Court could pass upon objections to the State's proof of claim. The District Court had found that it could, over the protests of the State based upon its novel theory of sovereign immunity. The Circuit Court sustained neither the State nor the District Court, for it allowed the Bankruptcy Court jurisdiction while reversing its order; but instead it passed to one of the substantive objections to the State's proof of claim and held that the objection was precluded by *Arkansas Corporation Commission* v. *Thompson, supra.*

The opinion of the Court of Appeals occupies ten pages in the Federal Reporter; and it is not unfair to say that,

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*298 U. S. 513 (1935).

apart from some attention given to the history of the case, five of those pages are devoted to description of New Jersey assessment procedure and the other five to comparison of the New Jersey procedure with the Arkansas procedure which in *Arkansas Corporation Commission* v. *Thompson* was held to be a final disposition of an assessment question. In other words, the Circuit Court erroneously assumed that the issue before it was an attack by the Trustee on the New Jersey method of assessing real property, a question which had not been briefed or argued. In fact, none of the substantive objections to the State's claim had ever been presented even to the District Court, because of the State's jurisdictional objection. The most expeditious procedure —and, incidentally, the one which the Trustee and intervening creditors desired—would have been to bring the jurisdictional objection of the State and the numerous substantive objections to the State's claim up for simultaneous disposition. But it so happened that the preliminary jurisdictional question rose all the way to the Circuit Court, which then looked over the jurisdictional question to the substantive question which it erroneously believed to be at the bottom of the case, and so disposed of the matter.

Not even the State thought, in its briefs before the Circuit Court, that the case was concluded by *Arkansas Corporation Commission* v. *Thompson*. The State did not rely on the *Arkansas* case until its brief in opposition to the petition for certiorari in this Court, and even then it seemingly picked up with reluctance the weapon forged by the Circuit Court. The Circuit Court's conclusion that the Bankruptcy Court may pass upon only "mathematical error in the computation of the amount of the tax, or legal error in assessment" is indeed at variance with the position of the State, and does not answer the sole question before the Circuit Court.

2. Loose reference to questions of law and pleas of *res judicata* as "jurisdictional" disguise the fact that the Bankruptcy Court very properly passed on nothing but the one jurisdictional question whether the State might claim sovereign immunity.

Sharp attention should be directed to a certain confusion in the use of the term "jurisdiction", which has permeated the State's position and contentions in this case and which has seemingly misled the Circuit Court. The State tends to elevate questions of law into questions of jurisdiction: *e. g.*, it argues that the bankruptcy court has no "jurisdiction" to review the assessment because of the *Arkansas* case; that it has no "jurisdiction" to uphold the objections to the State's claims because the state court litigation (to which the trustees were not parties) decided the question and is "binding"; that the bankruptcy court has no "jurisdiction" to look into the penalty interest because of the *Meilink* decision, and so forth.

These arguments are arguments of law which should be made to the bankruptcy court when it passes on the objections to the State's proof of claim. They do not go to the question whether the court may hear the objections. It may well be that the bankruptcy court will agree with the State in all these contentions. No one knows, because the bankruptcy court has never had the opportunity to pass on them.

The question of the binding effect of state law is not relevant to the question now before this Court. A bankruptcy court must first determine, in the nature of things, whether a question before it is one of state law or one of bankruptcy law; and second, if there is a question of state law, what the state law is; and third, to what extent rights under state law as thus established are to be preserved and

enforced in bankruptcy. The effect of the State's position in this case is to require the bankruptcy court to accept as final a state claimant's assertions on all three of these questions.

No such solution of State law questions can be applied to this problem because whether a question is one of state or Federal law, and how State law rights once established are to fare in a bankruptcy administration, cannot be so settled.

The Circuit Court, as we have demonstrated, did not in fact sustain the plea of sovereign immunity raised by the State; but it jumped over the jurisdictional objection and decided what it thought was the substantive question, although (a) none of the substantive questions have ever been briefed and argued and the record has not been completed nor come before any court; and (b) such a decision concludes not only these questions, but quite possibly questions not as yet raised or even conceived.

POINT III

The Circuit Court erred in holding that the District Court had no jurisdiction to determine whether a valid tax settlement had been made by the State and the Trustees in Bankruptcy.

1. By its holding the Circuit Court prevented a determination by the District Court of the question whether a valid tax settlement had been made by the State and the Trustee in Bankruptcy superseding the original assessment.

One of the most important substantive questions, not yet decided, is the effect of the acceptance by the Trustees of the offer made by the Tax Settlement Acts and action taken

thereunder. The Circuit Court of Appeals appears to have assumed that the decision of the New Jersey Court of Errors and Appeals,* holding these Acts unconstitutional in a case stated between the attorney general and the state treasurer, foreclosed any further consideration of the application of the Acts to the Debtor's tax liabilities.

Such assumption ignores the nature of the proceedings in that case, the extent to which it would bind the Bankruptcy Court, and the rules as to acquisition of rights which may be acquired under a statute which is later held unconstitutional.

Wilentz v. *Hendrickson* † was instituted by information filed by the attorney general of New Jersey, praying an injunction against the State Treasurer against enforcement of the Tax Settlement Acts. The case was tried upon the pleadings, upon affidavits, and upon stipulated facts (133 N. J. Eq. 451). Neither the Debtor nor any other railroad was a party to the proceedings. In spite of this opportunity so to frame the issues as to answer all possible defenses of the Acts, the Court of Errors and Appeals, in discussing the central issue of the case—whether the readjustment of liabilities was supported by consideration—referred three times to the insufficiency of the proofs, and emphasized *the lack of proof* that the taxes were "uncollectible" (135 N. J. Eq. 252, 256, 260).

In view of the lack of identity of parties, and of the court's own emphasis of the lack of proof on a controlling issue in the case, it is manifest that this decision is neither *res judicata*, nor a conclusive decision of the State Court which would be binding on the Bankruptcy Court: *Rutter* v. *Patterson*, 73 N. J. L. 467. If the Bankruptcy Court

* *Wilentz* v. *Hendrickson*, 135 N. J. Eq. 244.
† 133 N. J. Eq. 447.

should determine, on competent evidence, that the State tax claims were uncollectible in whole or in part when the Tax Settlement Acts became applicable, its decision as to their validity could, without running contrary to New Jersey law, differ from the decision in the *Wilentz* case.

There also remains completely undetermined the question of rights and equities the Debtor may have acquired by its action taken in reliance on the Tax Settlement Acts. These Acts were passed by the State legislature and approved by the Governor in the attempt to solve the apparently hopeless quandary of the railroads which were in reorganization, and to gain an advantage for the State in the shape of immediate tax payments. The solution offered by the Acts was accepted by the railroads, with the approval of the Bankruptcy Court, but after objection by the Attorney General of the State was made to its *jurisdiction*, the Circuit Court held in effect that the Bankruptcy Court had no power to decide whether the Debtor had so changed its position as to have acquired rights or equities. It is clear that rights protected by the contract clause cannot be defeated by the decision of the highest court of a State construing its own constitution (*Combes* v. *Getz*, 285 U. S. 434). It is equally well settled that vested rights acquired under a statute will not be destroyed by a subsequent declaration in a proceeding between different parties that the statute is unconstitutional: *Chicot County Drainage District* v. *Baxter State Bank*, 308 U. S. 371. In *J. A. Dougherty's Sons* v. *Commissioner*, 121 F. (2d) 700 (C. C. A. 3d) it was said (p. 703):

> "Nowhere is the propriety of recognizing and accrediting a status produced by a statute before its unconstitutionality has been judicially declared more strongly indicated than it is in the case of tax statutes. The subject taxpayer is under compulsion to pay due regard to the requirements of the statute

until its invalidity has been authoritatively adjudicated."

2. Whether such a settlement binding on the State has been made is a question of fact clearly within the jurisdictional competency of the District Court.

Neither the Bankruptcy Court nor any other court has been given the opportunity to receive evidence as to the effect of the action which the Debtor was required to take and did take in accepting the provisions of the Tax Settlement Acts. The nature of the rights and equities which it acquired by virtue of this action and their relation to the Debtor's estate as a whole must, it is submitted, be determined by the Bankruptcy Court.

It should be noted that no question as to the construction of either constitution or statute has arisen. The only question which will be presented to the District Court is whether *under the facts as they may appear* there was a donation. The contention that the amount of the original assessments of the State authorities is the final amount due is of no validity, for the State itself by passing the Settlement Acts reopened the question and made a new determination as to the amount of taxes due.

Conclusion

For the reasons stated above, the decision of the Circuit Court of Appeals should be reversed.

Respectfully submitted,

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APPENDIX

Pertinent Sections of the Bankruptcy Act

Section 2

"The courts of the United States hereinbefore defined as courts of bankruptcy are hereby created courts of bankruptcy and are hereby invested, within their respective territorial limits as now established or as they may be hereafter changed, with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this Act, in vacation, in chambers, and during their respective terms, as they are now or may be hereafter held, to— . . ."

(7) "Cause the estates of bankrupts to be collected, reduced to money and distributed, and determine controversies in relation thereto, except as herein otherwise provided, and determine and liquidate all inchoate or vested interests of the bankrupt's spouse in the property of any estate, whenever under the applicable laws of the State, creditors are empowered to compel such spouse to accept a money satisfaction for such interest."

Section 23 (a)

"The United States district courts shall have jurisdiction of all controversies at law and in equity, as distinguished from proceedings under this Act, between receivers and trustees as such and adverse claimants, concerning the property acquired or claimed by the receivers or trustees, in the same manner and to the same extent as though such proceedings had not been instituted and such controversies had been between the bankrupts and such adverse claimants."

Section 57 (n)—As Amended

"Except as otherwise provided in this Act, all claims provable under this Act, including all claims of the United States and of any State or subdivision thereof, shall be proved and filed in the manner provided in this section. Claims which are not filed within six months after the first

date set for the first meeting of creditors shall not be allowed: *Provided, however,* That the court may, upon application before the expiration of such period and for cause shown, grant a reasonable fixed extension of time for the filing of claims by the United States or any State or subdivision thereof: *Provided, further,* That, except in proceedings under Chapters X, XI, XII, and XIII of this Act, the right of infants and insane persons without guardians, without notice of the bankruptcy proceedings, may continue six months longer: *And provided further,* That a claim arising in favor of a person by reason of the recovery by the trustee from such person of money or property, or the avoidance by the trustee of a lien held by such person, may be filed within thirty days from the date of such recovery or avoidance, but if the recovery is by way of a proceeding in which a final judgment has been entered against such person, the claim shall not be allowed if the money is not paid or the property is not delivered to the trustee within thirty days from the date of the rendering of such final judgment, or within such further time as the court may allow. When in any case all claims which have been duly allowed have been paid in full, claims not filed within the time hereinabove prescribed may nevertheless be filed within such time as the court may fix or for cause shown extend and, if duly proved, shall be allowed against any surplus remaining in such case."

Section 57 (n)—Prior to Amendment

"Claims shall not be proved against a bankrupt estate subsequent to six months after the adjudication; or if they are liquidated by litigation and the final judgment therein is rendered within thirty days before or after the expiration of such time, then within sixty days after the rendition of such judgment: *Provided,* That the right of infants and insane persons without guardians, without notice of the proceedings, may continue six months longer."

Appendix

Section 64 (a) (4)—As Amended

"The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be . . . (4) taxes legally due and owing by the bankrupt to the United States or any State or any subdivision thereof; *Provided*, That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court: *And provided further*, That, in case any question arises as to the amount or legality of any taxes, such question shall be heard and determined by the court; and"

Section 64 (a)—Prior to Amendment

"The court shall order the trustee to pay all taxes legally due and owing by the bankrupt to the United States, State, county, district, or municipality, in the order of priority as set forth in paragraph (b) hereof: Provided, That no order shall be made for the payment of a tax assessed against real estate of a bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court. Upon filing the receipts of the proper public officers for such payments the trustee shall be credited with the amounts thereof, and in case any question arises as to the amount or legality of any such tax the same shall be heard and determined by the court."

Section 77 (c) (7)

"The judge shall promptly determine and fix a reasonable time within which the claims of creditors may be filed or evidenced and after which no claim not so filed or evidenced may participate except on order for cause shown, the manner in which such claims may be filed or evidenced and allowed, and for the purposes of the plan and its acceptance, after notice and hearing, the division of creditors

and stockholders into classes according to the nature of their respective claims and interests. Such division shall not provide for separate classification unless there be substantial differences in priorities, claims, or interests. The trustee or trustees under any mortgage, deed of trust, or indenture outstanding against the property may, within the time prescribed, file a verified claim in behalf of all bonds or securities outstanding under such mortgage, deed of trust, or indenture, in which event it shall be unnecessary for the holders of such bonds or securities to file claims in their own behalf, but nothing herein shall constitute such trustee or trustees the representative or representatives of such holders for the purpose of accepting or rejecting any plan of reorganization."

Section 77 (l)

"In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and its property, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed."